Ontario Energy Association

October 27, 2006

Ontario Energy Board
P.O. Box 2319, 27th Floor
2300 Yonge Street
Toronto ON
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Re: EB-2006-0088 (Cost of Capital) and EB-2006-0089 (2nd Generation IRM) – Ontario Energy Association (OEA) Submission

The Ontario Energy Association (OEA), on behalf of our Local Distribution Company (LDC) members, sent a letter outlining our initial concerns with the Cost of Capital and Incentive Regulation Mechanism (IRM) proposals on July 5, 2006. I would like to take this opportunity to reiterate these concerns, which are both significant and material to our LDC members and the broader LDC sector.

Ontario's LDCs play a key role in the delivery of reliable electricity to Ontarians. They are currently facing significant financial pressures for several reasons. First, major new capital investments in distribution infrastructure assets are required to ensure their continued reliability and to facilitate the connection and reinforcement of new generation and transmission being developed as a result of government procurements. Second, LDCs are responsible for implementing the government's aggressive smart metering and conservation objectives. Finally, despite recent small declines in commodity prices, continued upward pressure on energy prices is expected over the longer term.

Within this context, we are concerned that LDCs could be unfairly squeezed in an effort to minimize the impact of rising electricity prices on consumers' electricity bills. The government has made a commitment that consumers pay the true cost of electricity – a commitment we support. **We strongly believe that distribution infrastructure is an essential component of this cost structure and must not be overlooked as part of the true cost pricing commitment.** The reliability and quality of local distribution services that Ontarians have come to expect must remain paramount – and this does not come without costs.

In our earlier letter, we raised the specific and fundamental concern that the proposed range for Return on Equity (ROE) did not meet the fair or comparable return standards. Notwithstanding this concern, it appears that few if any changes to the methodology are being contemplated by Board staff.

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As strongly noted by the investment and debt-rating community – perhaps best illustrated by the comments of Karen Taylor, Managing Director, Pipelines and Utilities, BMO Nesbitt Burns – the proposed ROE range is expected to have a negative effect on investor confidence in the sector, which could drive up the cost of capital for LDCs. An insufficient return on equity could constrain investment in capital projects which, in turn, would have a negative long-term impact on distribution infrastructure. These are indeed disconcerting comments from the financial community and we would advise the OEB to weigh these "red flags" prudently in future deliberations.

We strongly suggest a reconsideration of the proposed methodology, in order to bring the calculated ROE more in line with North American benchmarks. In the past, ROE was developed using the Cannon methodology, which drew input from three different models including the Capital Asset Pricing Model (CAPM). Utilizing the "average" of the three models helped to mitigate the shortcomings of any particular model.

Using the CAPM model alone, as is being proposed, results in a range of returns that is clearly out-of-step with ROE awards for comparable regulated entities in other jurisdictions. **It is still not clear to us why the decision was made to adopt the CAPM model as a replacement for the more robust Cannon methodology. As a result, we suggest that the Cannon methodology continue to be utilized until additional due diligence is undertaken on whether or not a new methodology is warranted and, more importantly, whether it meets the broader fair or comparable return standards.**

We are also concerned about the proposal to create a one-size-fits-all debt/equity ratio. Moving to a uniform structure, especially in a short period of time, could impact the ability of small and medium-sized LDCs, many of whom have 50/50 debt/equity ratios, to obtain financing on reasonable terms and conditions. Unfortunately, this detrimental effect on capital costs will most likely be passed on to consumers through higher distribution rates. Overall, we would suggest that more time be taken to better understand the risk profile of the sector, in light of the factors discussed above, and to test the impacts of the ROE and debt/equity proposals on the ability of LDCs to raise capital.

With regard to IRM, the proposed 2nd Generation IRM does little to provide real long-term incentives to the LDC sector, given the short 1-3 year incentive terms that are proposed. We consider the 2nd Generation IRM simply as a transitional measure to bridge the gap until we have developed a more robust incentive-based regulatory scheme. **We suggest a concerted effort focused on developing the 3rd Generation IRM, starting immediately, to ensure it provides the important long-term incentives that support the sector's performance objectives, provide fair returns for LDC shareholders, and focus incentives to drive further efficiency and productivity gains across the sector – goals we all share.** On both IRM and Cost of Capital, our view is that incentives should be structured so as to encourage innovation, efficiency and productivity improvements for relative underperformers, rather than imposing up-front and arbitrarily stern measures on the entire sector.

Finally, on the matter of process, we share the concerns which have been raised about establishing codes to determine IRM and Cost of Capital. Codes are characteristically used to set operational and behavioral standards, rather than financial parameters and rates.

In conclusion, we remain strongly committed to incentive-based regulatory mechanisms and look forward to working with the Board and staff to address these concerns and develop robust and well-tested IRM and Cost of Capital proposals for the future. LDCs operate as commercial enterprises under the *Ontario Business Corporations Act* and it is critical that incentives reflect this important fact.

LDCs place the highest priority on the reliability and quality of service they provide to their customers. A fair return on equity, prudent capital structures and robust IRM are required to ensure that LDCs can attract the capital investments necessary to allow them to continue to deliver on this priority.

Sincerely,

Shane T. Pospisil
President and CEO
Ontario Energy Association

The 170-member Ontario Energy Association (OEA) is Ontario's premier energy trade organization, representing firms and organizations involved in the generation, transmission, distribution and marketing of electricity, and the transmission, distribution and marketing of natural gas across the province. OEA members together employ about 32,000 Ontarians and last year accounted for about $34 billion in market revenues.

cc: David O'Brien, Chair, Ontario Energy Association
OEA Utility Sector Committee